

**Remarks of  
Commissioner Linda K. Breathitt  
Federal Energy Regulatory Commission**

**"Responding to the Challenges of Competition"**

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Good morning! As most of you know, FERC is in recess during the month of August, so in many ways, this feels like the beginning of a new school year. I'm happy to start out this new "regulatory season" with the largest meeting of gas buyers in the Mid-Continent, the LDC Forum! And I am particularly delighted to share the floor with my NARUC colleague, Ruth Kretschmer, of the Illinois Commerce Commission. Over the next couple of days, you will delve into the many intricacies of the natural gas marketplace and pipeline-shipper relationships. This discussion comes at a perfect time for me to reflect on the ongoing evolution of competition in the natural gas industry and to share with you some of my thoughts, as a federal regulator, as to where we are going.

I think while Ruth and I look at competition from different perspectives, you will likely get the sense that we both view this as an exciting time in both interstate and retail natural gas markets. I'm sure we can all agree that the natural gas industry has fundamentally changed since the issuance of Order No. 636 in 1992. In the early 1990s, interstate pipelines provided a bundled sales service to mainly LDC customers. This bundled service usually included the gathering, storage, transmission and merchant functions. Today, pipelines as well as LDCs provide an increasingly broad array of unbundled services to a customer base more and more oriented to a fast-paced market. If you can remember back to 1992, many in the industry were concerned that the restructuring initiated by Order No. 636 would result in less reliable, more expensive service. But this has not been the case. Overall, today's market appears to be operating as efficiently as ever; market forces are increasingly relied upon to establish the character and the price of services.

After the issuance of Order No. 636, all sectors of the natural gas industry recognized the evolution in the market and responded accordingly. Interstate pipelines responded to market forces by implementing new services in order to expand shippers' options. Pipelines continue to seek FERC approval of innovative service options

tailored to meet the needs of various customer groups. Such services as park-and-loan and short-term firm transportation, which only recently were considered novel, have, in this past year, become commonplace. Pipelines have proposed new services, such as East Tennessee's Storage Delivery Option, to assist shippers in mitigating unauthorized overrun charges. Offshore pipelines have begun to implement special Flexible Firm Transportation services that are specifically tailored to conditions on the offshore. We also have begun to approve proposals for "quasi-firm" transportation services -- to address the needs of shippers who generally require firm service but are able to accommodate periodic service interruptions. And we recently approved a plan by Reliant Energy Gas Transmission Company to offer, through the use of Internet contracting and real-time metering, an hourly firm natural gas transportation service to meet the needs of electric generation shippers.

Federal regulators, of course, aren't the only ones who get to see how well all participants in the natural gas industry have responded to competition. Open-access in interstate markets has contributed to the development of competition in retail markets as well. Retail unbundling is being planned and implemented in many states. Here in Illinois, for example, there are three active pilot unbundling programs currently underway, operated by Central Illinois Light, Northern Illinois Gas, and Peoples Gas. But this is Ruth's bailiwick, and I'm sure she will have a lot to tell us about retail competition.

As a federal regulator, I am committed to promoting retail unbundling where it has been determined -- at the state and local level -- that it will benefit all consumers. While the varied unbundling programs and the timing of those programs can create some temporary uncertainty in interstate transportation markets, I must say that I would oppose any federally-mandated "one-size-fits-all" approach. I doubt there is any supply and demand model that fits every jurisdiction. But where retail unbundling is found to be appropriate, I believe that federal regulators can serve to facilitate market transitions. We have been asked, several times, to waive certain of our gas pipeline policies and regulations to permit the implementation of state unbundling initiatives.

I have taken the approach that FERC should be flexible enough to accommodate different state programs wherever possible in our overarching goal to promote competitive markets. One aspect of our open-access policy that we may need to revisit is the "shipper-must-hold-title" policy. This particular policy has implications for many state unbundling programs, and it is one that we have been requested to waive in two cases. I would not be surprised if we did not receive more such waiver requests in the future as retail unbundling develops.

Indeed, the natural gas industry, as a whole, has responded remarkably well to the changes that have occurred in this decade. Even though the market is vibrant, FERC is at an important crossroads in its regulation of the natural gas industry. Not

only must we consider the effect of competition on participants in natural gas markets, but we must look at the development of a broader, more integrated energy market. And this is changing the way we regulate. At FERC, we recognize that there do exist some real barriers to competition and convergence, and we are asking ourselves and the industries we oversee how we can remove those barriers. We realize a need to become more proactive in order to set the stage for what is sure to be an exciting new era for the energy industry.

This past year at FERC, we have proposed and implemented several policy changes that directly reflect market changes and integration. One year ago, the Commission issued a Notice of Proposed Rulemaking (NOPR) on the regulation of short-term transportation services as well as a Notice of Inquiry (NOI) on long-term pricing policies. This initiative represented a comprehensive policy undertaking that included many questions and ambitious proposals, and we are now in the process of deciding how to respond to the public comments on this initiative.

These policy pieces literally covered the waterfront of issues currently facing the natural gas industry. The NOPR and NOI placed on the table such matters as daily auctions of pipeline capacity, individually negotiated terms and conditions of service, changes to allow greater transparency, a reexamination of pipeline penalty procedures, an inquiry into the Commission's pipeline certificate policies, and ratemaking options for the long-term. From there, the Commission and its staff have engaged in a year-long discussion of these issues and are assessing what needs to be done next. To me, the long and short of the matter is that even though market power continues to exist in the pipeline industry, competition is moving forward in a fairly healthy manner. While I don't envision a need for an immediate overhaul of our natural gas policies, though, there is a fair amount of adjustment we can make to further facilitate the process.

The aspect of the NOPR that got the most attention was the proposal to require a daily capacity auction to reflect a faster-paced energy market. The proposal of a daily auction was essentially a quid pro quo for releasing the price cap in the short-term market. I continue to believe that auctions generally can be used to mitigate market power. But, as I indicated when we issued the NOPR, there continue to be many implementation and cost issues that need to be resolved in order for daily capacity auctions to become viable. It would be fair to say that the comments we received from the industry do not support the pursuit of a daily auction rule at this time. Several pipelines are currently using auctions to allocate longer-term capacity, and there is much we can learn as these programs are implemented.

With respect to lifting the price cap in the short-term market, the industry's response has generally been that it would prefer to pursue ratemaking proposals such as seasonal rates or term-differentiated rates. My initial reaction is that I would consider term-differentiated ratemaking a means to allow the pipeline and shippers the

opportunity to structure service agreements that are more responsive to present market conditions, while still retaining a cost basis. For me, the positive element of this ratemaking method is that it is cost-based, and therefore does not have the inherent market power issues that releasing the price cap presents.

The other "splashy" element of the NOPR was FERC's proposal to permit pipelines and their shippers, under a specific set of guidelines, to individually negotiate terms and conditions of service. This proposal reflected our recognition that pipelines and their customers need flexibility to adapt to a more dynamic and integrated energy market. I believe that the Commission should encourage and promote pipelines to provide flexible services. However, I would prefer that the flexibility be implemented through generally available rate schedules that permit other shippers who are similarly situated to also have these services if they want them.

Our current regulatory model allows us a great deal of flexibility in approving such innovative and progressive proposals. As I indicated earlier, pipelines have been offering many new service options to respond to the needs of the evolving energy marketplace. More importantly, these services are generally available, and other firm services are not degraded by these new services. So, I don't see where our current policies on authorizing services are unworkable. The availability of more options for shippers should serve to increase competition. And more competitive markets may allow us to permit more light-handed regulation and allow the market to more freely determine the appropriate prices for services.

But as I have noted, there are some elements of the NOPR that I believe FERC should pursue in order to enhance competition, and we are likely to act on at least some of these matters in the near future. From my perspective, one of the most attractive features of the gas initiative is the effort to improve transparency in the marketplace. I take the position that transparency is an effective deterrent against market power. The additional operational and pricing information that the Commission is proposing is intended to give the market tools to allow for more self-policing by the industry.

One example is the transactional information for capacity release that we currently require, as opposed to the transactional information that is required for the pipeline's own capacity. For capacity release transactions, pipelines provide, via the Internet, the names of the releasing and acquiring shippers, the price, the receipt and delivery points, the quantity involved, and the duration of the transaction. This data is posted immediately upon completion of the transaction. The same information about pipeline transactions is currently not as complete, nor is it as timely or easy to access. Pipeline discount reports aren't filed until 15 days after the close of the billing period. These reports do not include any information on volumes, the receipt and delivery points, or the duration of the transaction. To enhance transparency with regard to

transactions, the Commission is proposing that pipelines be required to provide the same information about their transactions as is currently provided about capacity release transactions.

We are also proposing changes in pipeline penalty procedures. The NOPR takes the position that penalties are necessary to deter conduct that impedes system operation -- but that they should not necessarily limit shippers' competitive alternatives. Now we are considering whether we have permitted pipelines too much discretion in this regard, and whether the emphasis should be reoriented away from penalties and toward providing opportunities for shippers to avoid penalty situations. This is an approach that make sense to me.

I am aware that the right of first refusal is an issue of significant importance to LDC shippers. I understand that many of you believe that the right of first refusal is needed to safeguard against the exercise of market power when pipelines have pregranted abandonment authorization. I also know that many LDCs view the right of first refusal as particularly important during this time of transition, especially where state unbundling has not been fully implemented. As the NOPR pointed out numerous times, market power continues to exist. This will guide my decision as I decide whether the right of first refusal should be retained.

And finally, since today's program is all about the natural gas business in the Mid-Continent, I would be remiss not to touch upon recent FERC activity regarding certificate policies. Much of the Commission's pending certificate caseload pertains to projects in this part of the country, but I can only remark on the general policy issues currently at play. Recently we have faced what has been called a "new generation" of certificate issues that have strained the limits of our existing policies concerning landowner rights, environmental impact, the pricing of new facilities, and the way we determine if there is sufficient market demand to justify the certification and construction of new pipeline projects. These issues have become of even greater importance as shippers -- and, of course, state commissions -- contemplate the costs associated with pipeline overbuilding and capacity turnback. Some industry sectors advocate a reexamination of the Commission's "at-risk" policy as a protection against cost shifting due to overbuilding. At the same time, the Commission is urged to consider the development of additional pipeline capacity as a means of mitigating market power.

My goal is to achieve a balance in our handling of construction and capacity pricing issues, so that facilities are constructed where demand warrants construction, while at the same time guarding against additional construction that is not necessary to meet any increase in demand for capacity. I am committed to encouraging competition. But another important role of the Commission is to avoid overbuilding and associated stranded costs, disruption of the environment, and unnecessary exercise of eminent

domain over private property. The differences in opinion arise in exactly where that balance lies. I believe that it is incumbent upon the Commission to facilitate new pipeline construction -- where it is needed to meet market demand, and where such construction can be achieved with minimal environmental effects.

FERC currently has pending a NOPR seeking to give affected landowners earlier and easier access to information concerning those aspects of certificate applications that impact them. I fully support that goal. The trade press has announced that we are on the brink of issuing another document that would announce a new policy on construction issues. I would not be talking out of school, then, to say I would expect some kind of policy pronouncement in the near future - if not in a generic policy piece, then in individual cases. What we are attempting to develop is a means for the Commission to balance need and public benefits, versus landowner and environmental concerns over new construction. My personal objective in issuing a new policy would be to permit the development, in individual cases, of a record that is complete enough for the Commission to make an adequate assessment of need. But more importantly, I believe any policy pronouncements we make should serve to add certainty to the process.

And what do I think will happen to the rest of the NOPR and NOI issues? After reviewing the comments we received, I know I am not alone in my belief that the time isn't right for a massive policy shift. Overall, I believe one reasonable approach would be to issue a Final Rule which promotes term-differentiated rates. The Rule could signal an increased willingness on the Commission's part to allow new services which provide flexibility needed to respond to the changing pace and the changing faces in the natural gas marketplace. The Rule could also implement changes to enhance transparency and address the penalty issue. I think these changes will go a long way to enhance competition in interstate markets. From what I've read in the comments, the approach I am proposing appears to be one that many in the market could support. So as we face the questions that the NOPR and the public comment present, perhaps the wise decision would be to continue to make progress on our present course, with appropriate adjustments. We can -- and should -- continue to analyze whether more extensive changes to our policies are necessary in the long-term to equip the industry with the tools needed to compete in the twenty-first century.

Before I close, I would like to encourage all of you to continue to respond to the challenges of competition with the same initiative, enthusiasm, and creativity you and your companies have demonstrated up to now. I thank you for the opportunity to participate in your discussion today, and I wish you the best for a successful conference and a great year.

